TITLE
Tax after coronavirus – evidence to Treasury Select Committee inquiry

AUTHOR
Booth, Philip Mark

DATE DEPOSITED
20 August 2020

This version available at
https://research.stmarys.ac.uk/id/eprint/4248/

Tax after coronavirus – evidence to Treasury Select Committee inquiry

Philip Booth BA PhD FIA FSS

Professor of Finance, Public Policy and Ethics, St. Mary's University, Twickenham

Senior Academic Fellow, Institute of Economic Affairs

August 2020

Executive summary

- Neither changes in environmental factors nor changes in working practices are having a significant effect on public finances or the efficiency of the tax base.
- Overwhelmingly, the major factors leading to pressure on public finances are arising from demographic trends. The Office for Budget Responsibility's (OBR) reports on such matters are becoming ever-more bleak.
- This problem arises because of decisions that could have been, but were not, taken from the early 1990s onwards. However, government policy since 2010 has exacerbated the problems caused by population ageing, and the current government has made things worse. This has been made clear in the OBR's Fiscal Sustainability Report.
- The fiscal situation is so serious that it is highly undesirable and probably impossible for all adjustments to fiscal policy to take place by increasing taxes.
- Radical fiscal decentralisation and tax simplification would be desirable. Decisions should also be taken to reduce unjustifiable spending promises such as the triple lock on pensions.
- Our tax system is incoherent and far too complex due to years of the tax system being used to make political points or respond to vested interests.
- A range of radical tax simplifications and abolitions is proposed. Some of these would lead to more revenue being raised.
- A wealth tax is wrong in theory and would be impossible to implement in practice. There are aspects of the tax system that allow certain forms of actual and imputed income from wealth to remain untaxed. These issues should be addressed directly, and there should not be a tax specifically on wealth.
- The arguments concerning the corporate tax base and globalisation are over-egged. Corporation tax receipts continue to rise and the so-called "tax gap" has narrowed to the lowest levels recorded. However, there are reforms to corporation tax which could be considered on their own merits.
- The Digital Services Tax has no merit and is a tax on innovation. It should be withdrawn.
- Given the dire state of the UK tax system following the Brown/Osborne era and the perilous state of the public finances as a result of a number of short-term decisions being taken, it is necessary for the government to put "ideas" and "principles" above interests and articulate a clear tax policy. As many elements of reform as possible should be enacted simultaneously to avoid reforms being picked off or made more complex in response to lobbying.

What are the major long-term pressures on the tax system in the UK, including those arising from changes in working practices, demographics, the environment and other factors? How are these affecting the efficiency of the tax base and the overall level of demand for public services?

What overall level of taxation can the economy bear without undesirable or counterproductive harm to economic growth?

Fiscal pressures

Overwhelmingly, the major long-term pressure on the UK tax system is arising from demographic changes. Environmental concerns do not take a large part of government spending. Indeed, the most efficient way to address environmental concerns would be through the levying of carbon taxes and the removal of tax-subsidies on domestic fuel consumption. The fact that the government chooses not to follow such policies is damaging to economic efficiency and the achievement of environmental objectives. This is, though, a political choice. But, in general, the achievement of environmental objectives is not putting huge pressure on either tax revenues or government spending.

Changes in working practices are having a marginal effect on the tax system. It is often argued that the increase in the proportion of self-employed people (from 12 per cent of the workforce to 15.3 per cent of the workforce since 2000 according to ONS figures) erodes the tax base. This can happen because of the more favourable tax position facing self-employed people. This includes allowing deduction of expenses, the ease of evasion and avoidance, and lower National Insurance contributions on self-employed earnings. However, this change in working patterns towards self-employment has been overwhelmed by an increase in employment by over 17 per cent in the same period. This has arisen partly as a result of migration but also because of increased labour-market participation. In particular, the movement of women from working in the home to working in the labour market moves people from untaxed work in the home, to taxed work. There has also been increased labour market participation by older people. These trends reinforce the tax base and offset any reduction in the tax base caused by increases in self-employment.

Nevertheless, given the increase in the Basic State Pension at the expense of the Second State Pension (with the latter not being available to the self-employed), there is a strong case for equalising self-employed and employee National Insurance contributions. State pension provision for employed and self-employed people is now the same. Equalisation of employees' and self-employed National Insurance contribution rates would still leave a position where self-employed people paid lower rates overall because of the absence of an equivalent of employer's National Insurance in the case of the self-employed. However, this can be justified because they do not receive some benefits that are received by employed people.

There was a great deal of discussion about the influence of demographic factors on long-term public finances in the 1990s, including work by the OECD and IMF[1]. There

---

[1] See, for example, Chand S.K. and Jaeger A. (1996), Ageing Populations and Public Pension Schemes, International Monetary Fund Occasional Paper No. 147, IMF and Roseveare D, Leibfritz W, Fore D. and Wurzel

was also much debate and a general cross-party consensus that something needed to be done to avert the crisis with the Conservative Party proposing particularly radical policies in the 1997 and 2001 general elections. This was really the last time at which serious action could have been taken to avert the demographic crisis and the opportunities were not taken. Systems of pay-as-you-go social insurance have, and will continue to, create inter-generational conflict. This should not be a party political or a philosophical issue. It is possible to have pre-funding of pensions and healthcare with any amount of or combination of private or state involvement. This matter, however, is one of inter-generational distributive justice which has been compared with climate change by the former Irish Prime Minister John Bruton.

Although several policies were proposed to increase pre-funding of pensions by both main political parties in the mid-1990s, almost every decision that has been taken by successive governments since then, but especially since 2010, has made the situation worse. Examples of policies that have exacerbated the impact of population ageing on public finances include the removing of contracting out of state pensions; increasing the basic state pension dramatically; the use of PFI and PPP arrangements (though this is not related directly to population ageing, many of the contracts are connected to healthcare); increases in means-tested benefits for pensioners; the introduction of the winter-fuel allowance; free bus passes and free television licences (the latter now transferred to the BBC and rescinded); and the triple lock on state pension increases. Attempts to reduce pension entitlements of public sector workers have had very little overall influence on future costs. The one policy that has alleviated the costs of population ageing has been the raising of the state pension age and the linking of state pension age to longevity.

This pattern is predictable. Academic work, reviewed in Booth (2013)[2], strongly suggests that, as the electorate ages, there will be a tendency for policy to lead to increased spending on older people beyond that which is required by demographic ageing alone. The exception to this is that it is politically feasible to raise state pension age despite an ageing population.

The extent of the pressures on public finances caused by insufficient pre-funding of pensions and almost no pre-funding of health care is immense. The Office for Budget Responsibility's (OBR) Fiscal Sustainability report produces projections compatible with those of the best academics working in this field, such as Gokhale (2014)[3]. The OBR's projections should be seen in the context of a failure to meet fiscal targets consistently in the last 15 years. At every point, the present has been put before the future (as, again, is predicted in the academic literature). On present policy, the OBR projects, in its central scenario, that the debt-to-GDP ratio will rise to 400 per cent in the next 50 years. Policy decisions between October 2018 and March 2020 had previously added 100 percentage points to that projection, demonstrating the inability

E. (1996), Ageing Populations, Pension Systems and Government Budgets: Simulations for 20 OECD Countries, OECD Economics Department Working Paper No 168, OECD.

[2] Booth P M (2013), 'State Pension Reform in a Public Choice Framework', *North American Actuarial Journal*, 17(1), p.82-97.

[3] Gokhale J. (2014), *The Government Debt Iceberg,* Research Monograph 68, Institute of Economic Affairs, London, UK.

of government, even in normal, pre-covid times, to take prudent fiscal action. Before October 2018, taxes would have had to be increased or government spending reduced by one percentage point of national income each decade to stabilise debt-to-GDP levels at 75 per cent. If you read that quickly, it does not seem significant! However, if taxation takes all the burden of adjustment, this would mean a rise in taxation of more than one-seventh of current levels (or a 14 per cent increase in the average tax bill).

But, this was before measures taken by the government between October 2018 and March 2020. These decisions to increase government spending nearly doubled the necessary adjustment (OBR, Fiscal Sustainability Report 2020, 4.21) to 1.9 percentage points of national income per decade. The covid episode adds a further percentage point per decade so that spending has to decline or taxes rise by 2.9 percentage points of GDP per decade to stabilise the debt at 75 per cent of national income.

It is frequently argued that, because the UK is in the middle of OECD rankings of countries by tax burdens, there is scope to increase the tax burden further in the UK. However, rises in taxation of this magnitude would make the UK the highest taxed country in the OECD. Furthermore, the UK's whole approach to fiscal management has left it with little headroom to respond to future crises, especially given the ageing population. It is also dangerous to suppose that the UK should err towards adopting the most centralising aspects of government policy from each of our neighbours. Whilst the UK has a lower tax burden than Germany and Scandinavian countries, regulatory burdens are higher in the UK; the land-use planning system is more onerous; the provision of welfare is more centralised; and government spending and taxation are much more focused on the central government level than such countries. Imposing German tax levels on the rest of the UK fiscal and regulatory system could be crippling.

Thus, if there is to be an increase in the tax burden, it will be important to look at many other aspects of government fiscal and regulatory policy simultaneously to ensure greater decentralisation and the freeing of markets more generally. There is broad agreement amongst economists that the shape of the UK tax system and the centralisation of fiscal decision making are extremely inefficient.

How much should taxes rise?

It is asked at what level of taxation can be borne without detrimental effects on the economy. Booth (ed) (2016) suggests that the growth-maximising share of government spending in GDP is probably in the range 18.5–23.5 per cent of national income. However, the objective of policy never has been to maximise economic growth. The same work argues that the welfare-maximising share is probably in the range 26.5–32.5 per cent of national income (levels achieved by Australia, South Korea and Ireland in recent years). Growth will fall as the attempted tax take increases. At some point, which is very difficult to determine, the impact of tax on growth will be such that tax revenues will actually fall, and attempts to increase tax will then be totally counterproductive (often known as the "top of the Laffer Curve"). There is no widespread agreement about at what point this happens. However, it can be said with a reasonable amount of confidence, that it is somewhere between the current tax burden and the tax burden that we would have, if the adjustment to public finances arising from demographic pressures fell entirely on the tax side – given the current shape of the UK's tax system (discussed below).

Although politicians (including Conservative politicians), often talk about the revenue maximising tax burden as being the "optimal" tax burden as if the objective of government policy should be to maximise tax revenue. As explained above, the optimal tax burden is a long way below the revenue-maximising level. Moving the tax burden up from current levels to those suggested as necessary for fiscal sustainability by the OBR would have a significant impact on economic growth (thus partly undermining the objective of balancing the budget). The evidence seems to suggest that a 10 percentage points increase in the ratio of taxation to national income reduces growth by 0.5–1.0 per cent per annum. Indeed, an OECD study has suggested that up to one-third of the growth deceleration in the OECD between 1965 and 1995 could be explained by higher taxes.

The government has stated that there will be no return to austerity. However, the government's own analysis shows that this is not a viable policy option. There are three options in the medium term:

- Public sector austerity (reductions in government provision and welfare)
- Private sector austerity (increases in taxation)
- Austerity for the next generation (continue to postpone difficult decisions).

To conclude the answers to these key questions, it is very clear that increases in taxation cannot bear all the burden of future fiscal adjustment and that, to the extent increases in taxation bear any of the burden, there will be an adverse impact on productivity and growth which will have a second-round impact on tax revenues. There would be significant improvements in the productivity of government spending and a reduction of the adverse impact of taxes on the economy if there were to be significant tax simplification and fiscal decentralisation. The government could take a number of measures immediately that would reduce government spending headwinds going forwards. These would involve reversing measures that were taken with the overt objective of appealing to voter interest groups:

- The triple lock on pension increases has no justification. It should be replaced by a basic state pension that increases in line either with wages (so that pensioners share both the benefits and the risks of general economic growth) or prices (so that pensioners' incomes are guaranteed in real terms).
- The Winter Fuel Allowance has no rational justification now that the basic state pension is above means-tested benefit levels. It should be removed and means-tested benefits uprated to compensate for those pensioners receiving means-tested benefits.
- Student loan repayments should begin when earnings are at the personal tax allowance, thus reducing moral hazard, increasing government revenue, and reducing the need for government to interfere in the business models of universities.

Do these pressures need to be met with tax reform, and if so, is this the right time for reform?

Which areas of the tax system are most in need of reform, and which are best left alone?

What reforms should be considered in response to the pressures on the tax system?

What are the areas for simplification?

Given the totally incoherent nature of the UK tax system, reform of taxation would be desirable even without the fiscal headwinds of the next 50 years. For many years, the UK tax code has been cited as one of the longest and most complex in the world and the situation has become worse rather than better in the last few years. Many areas of taxation are entirely incoherent and incomprehensible to taxpayers. The list of taxes the structure of which lacks any obvious rationale has grown dramatically. Stamp Duty, National Insurance, Inheritance Tax, the taxation of dividends and the taxation of rented property have all become totally incoherent, sometimes penal and much more complex.

The growing complexity of taxation was a process that started in the recession of 1991 when the government was desperate to reduce the budget deficit. The process continued after 1997 but really picked up pace after 2010. Almost every tax decision in the post-2010 period, no matter how minor, had a political edge. For example, following the changes to the taxation of dividends in 2015, basic rate taxpayers have an effective rate of tax of 25.075 per cent on dividends after allowing for corporation tax paid on company profits. However, no tax is paid on the first £2,000 of dividends. No tax payer, whatever marginal rate they face, pays a rate of tax on dividend income that appears anywhere else in the UK tax system!

The incomprehensible nature of the tax system brings taxation into disrepute and undermines the accountability of the government to taxpayers. The incorporation of an allowance for main residence in the Inheritance Tax system – something which had no economic justification – made a simple tax extremely complex and provided perverse disincentives for older people to remain in their homes. In 1996, there was one rate of Stamp Duty that applied to all transactions. Today, in England alone, there are four different rates for domestic property, in addition to a supplement for a second property (a supplement which applies if a married couple has two properties between them but which does not apply to cohabitees in the same circumstances). There are also different rates and/or rules for corporate bodies, transactions of six or more properties, shared ownership properties, multiple transfers or purchases and companies and trusts buying residential properties. There is a set of rules in relation to each of these categories and complex provisions that determine which transactions fall under which category (for example whether granny annexes are separate residences). All such rules are totally unnecessary when there was one single rate of Stamp Duty.

The Institute for Fiscal Studies produced a landmark document in 2011 called *Tax by Design*. This was a good title, even at that time. In the intervening years, we have moved further and further towards “taxation on the hoof” – though this is perhaps a generous description given the deliberate politicisation of decision-making.

At the micro-level, tax policy has totally lost its coherence. It would appear that the Treasury itself has been politicised and/or lost its expertise in tax policy and public finance. For example, the limitation of the extent to which interest could be classed as a business expense in relation to rented properties led the Institute of Chartered Accountants of England and Wales to comment: “The idea that landlords will be taxed on the profit of their businesses, but not be allowed to offset the costs of creating that taxable profit is absurd, unjust and unsustainable. It overturns a fundamental, centuries-old principle of taxation”. This was one of the more polite comments by tax experts. The justifications for the measure from the Treasury itself (not just government ministers) suggested a lack of understanding of even the basic principles of public finance (see Beck and Booth, 2019)[4].

Given this starting point, every area of our tax system is ripe for reform and simplification. Some brief suggestions are given here:

- Both Council Tax and Stamp Duty are badly designed taxes. The ideal tax to levy on residential property would be a tax on imputed rent or the user cost of housing. Something akin to this is proposed both in Booth (ed) (2016) and in *Tax by Design.* Such a tax could be at the standard rate of VAT. An alternative would be a tax on all residential property values at a low rate which approximately mirrored a tax on imputed rent (for example, approximately 0.8 per cent of the value). Such a tax should replace both Council Tax and Stamp Duty in their entirety. To ensure consistency, it would also have to replace taxes on rents received from let residential property. It would also be paid by owners of UK property who were tax domiciled or resident abroad. This tax could be used (and varied) by local government, thus decentralising tax-raising powers given that the yield would be greater than the yield for Council Tax. However, it is important that the local government tax base is both broad and seen to be broad. As such, such residential property taxes should be separated out from rental calculations on all forms of let tenancy in the same way as, for example, Insurance Premium Tax is separated from insurance premium quotations. Revaluations must be undertaken frequently. Such a tax would also be an appropriate replacement for business rates.
- The UK Inheritance Tax system taxes estates rather than inheritances and it is therefore misnamed. Relatively few countries now levy either an estate or an inheritance tax and, ideally, this tax should be abolished. However, a relatively simply reform has been proposed by a number of tax analysts which would make the tax fairer, more efficient, less easy to avoid and make avoidance less worthwhile. If abolition cannot be countenanced, such a reform is suggested. On the grounds of equity, it would seem more appropriate to levy taxes on gifts received rather than on estates, as happens in most countries in which such taxes remain. Inheritance Tax should, therefore, become a tax on gifts received.

[4] Beck R. and Booth P. M. (2019), *Taxation without Justification: An economic analysis of the Treasury’s treatment of privately rented housing,* Current Controversies, 68, Institute of Economic Affairs, London, UK.

There should be no exemption for the main residence in such a system. A tax would be levied on the receipt of all gifts over a limit of around £5,000 per annum. The amount of the gift over £5,000 would be added to an individual's income for tax assessment purposes. There would be some exemptions to this. Charities would not pay tax on gifts received. Gifts placed directly into pension pots would bypass the tax system. Transfers between spouses should be tax-free and gifts to children could be taxed at a rate of around 20 per cent above once a lifetime allowance of, for example, £500,000 is passed. Such a system would be simple and make avoidance less worthwhile and more difficult.

- VAT should be charged at the standard rate on domestic fuel use. We have a very narrow VAT base by international standards and exempting domestic fuel from VAT works directly against other declared government policy objectives.
- The BBC should be turned into a subscription service and the TV licence abolished.
- The tax-free lump sum from pensions should be limited to about £50,000 (with that limit fixed in nominal terms). This would hugely reduce the incentive to use pensions as a tax avoidance vehicle and large amounts of regulation in relation to maximum contributions to pension schemes could be swept away.
- National Insurance should be considerably simplified. Categories H, M and (by implication) Z should be abolished. The rule by which a National Insurance allowance is given for each job, which makes the system fiendishly complicated (and sometimes makes errors literally impossible to correct), should be replaced by a system that collects National Insurance in the same way as income tax with adjustments being made through self-assessment. Further simplification would come from aligning the National Insurance and Income Tax thresholds (though not necessarily only be raising the former). I do not propose the merging of income tax and National Insurance. Indeed, the latter could be extended as a concept to move health provision in the UK onto a more insurance-based footing.
- The additional taxes on banks (the additional corporate tax and the bank levy) are arbitrary and should simply be abolished.

What is the right balance between taxation of work, savings/pensions and wealth?

The question is raised about the taxation of wealth versus income. This is something that Conservative parliamentarians regularly raise, as if a shift to a wealth tax base makes sense or could be efficiently administered. While a case can be made for taxing wealth on acquisition through gift (see above), a general tax on wealth would be both wrong and dangerous. Wealth is either accumulated out of past income which has been taxed on acquisition, or is a reflection of future income which will be taxed when it is received. Individuals who accumulate wealth through housing, land or securities do so out of income which is earned and taxed. Of course, that wealth may grow in value. It may do so as a result of falling interest rates or changing perceptions of risk or as a result of increases in expected future income streams, this being especially important in relation to shareholdings of start-up businesses.

To tax wealth that has been accumulated from past taxed income is a direct and dangerous attack on property rights which has no obvious limits. It is also an effective double tax on that part of income which is saved and which thus contributes to the accumulation of wealth and economic growth. Furthermore, it is unfair to tax business assets which have a value because of anticipated future profits when those profits will, themselves, be taxed.

A wealth tax is very difficult to administer. Not only do assets have to be valued each year (this would include homes, furniture, art, jewellery, antiques, cars, boats, pension rights, businesses, farms and other land and intellectual property), but there will be large numbers of people who simply do not have the cash to pay the tax. This will especially be the case with start-up business owners or owner-occupiers. Often exemptions are made for such groups, but this leads to the different treatment of similar assets and reduces the tax yields to trivial levels. This is especially so because debt can be taken on to buy exempted assets, thus reducing the net assets that are subject to the tax. Only Switzerland has a significant yield from its wealth tax, but other taxes in Switzerland are much lower than in other OECD or European countries.

A tiny wealth tax represents a huge effective tax on the income from wealth. For example, in a situation where real risk-free interest rates are one per cent (higher than current levels), a wealth tax of 0.5 per cent is an effective 50 per cent tax on the risk-free return from wealth which needs to be added to any tax that is directly levied on income from wealth.

Unsurprisingly, most countries that have had a wealth tax have, in recent years, abolished it. They have found it impossible to administer and/or found that wealthy individuals simply moved to other jurisdictions. There is a case for taxing receipts from inheritances, but this is best done in the way discussed above. It can also be argued that residential property is under-taxed (especially owner-occupied property). Again, higher yields and a fairer and more economically coherent system would be achieved by following the reforms suggested above. There is also a case to be made that, in some circumstances, pension wealth is under-taxed. Again, this is best addressed directly in the way suggested above.

It should also be noted that the tax base has become “dangerously narrow” (in the words of the Institute for Fiscal Studies) with a small number of better-off people paying a higher proportion of tax whilst those on lower incomes are exempted from tax through devices such as raising thresholds. Taxing wealth, assuming that the necessary exemptions to make the tax practical were applied, would narrow the tax base further by focusing tax collection on a smaller number of wealthy people.

What more can the UK do to protect its tax base from erosion as a result of globalisation and technological change, and what further impacts will the coronavirus pandemic have on our tax base?

There is little evidence that the UK tax base is being eroded by globalisation and technical change. Despite reductions in rates and the continuation of trends in relation to the globalisation of capital markets, corporation tax receipts have continued to rise.

According to HMRC's figures, the gap between the total tax that should be payable and tax that is collected continues to fall and is now at the lowest levels since the figure was first computed. There is widespread mischief-making by organisations such as the Tax Justice Network who campaign about issues such as tax havens. However, the reality is that tax havens are generally used for legitimate purposes. For example, they aggregate capital from a wide range of jurisdictions which have different tax systems to ensure that investment vehicles are tax transparent and that owners of such vehicles (which may include charities and pension funds) are not taxed more than the rate of tax intended in their country of residence.

When it comes to multi-national organisations, there are issues, of course, with transfer pricing, intellectual property and other mechanisms designed to reduce the tax burden on corporations. These lead to a great deal of subjectivity in relation to tax assessments. This, in turn, raises the cost of tax collection and can reduce revenues from profit shifting. Various mechanisms have been proposed to deal with this problem. One approach is for the government to carry on with its current approach to preventing avoidance whilst keeping the corporation tax system more or less intact. This submission's preferred approach is to move to a system whereby earnings per share are imputed to shareholders and taxed in the country of residence of the shareholder. This could be combined with other taxes levied by countries in which companies were operating so that those companies were contributing to the cost of basic government services. Other approaches have been proposed by, for example, Prof. Devereux of the University of Oxford.

The government is implementing a Digital Services Tax which, though it is often suggested that this is to level the playing field between companies that pay Business Rates and those that do not, has the declared purpose of dealing with corporate tax avoidance in mobile companies. This is effectively a tax on innovation and is another example of tax policy being developed on the hoof in a way that works directly against other government policy objectives designed to promote innovation. It is a very bad way to deal with the perceived problem.

What is the best way to tackle tax reform, including what changes might be needed at HMRC to support implementation, and how should the Government consult with stakeholders and parliament?

The lessons from political economy are that tax reform needs to be undertaken as a clear programme, underwritten by clear principles. The tax system has evolved in the way it has and the public finances have such long-term fragility, because of successive governments responding to interest groups. Sometimes those interest groups have been clear in their objectives and this genuinely presents a problem for government. In other cases, such as with the triple lock on pensions or the taxation of let property, the government has tried to ingratiate itself with voter groups without responding to specific campaigning or lobbying. Given the dire state of the UK tax system following the Brown/Osborne era and the perilous state of the public finances as a result of a number of short-term decisions being taken, it is necessary for the government to put "ideas" and "principles" above interests and articulate a clear tax policy. As many elements of reform as possible should be enacted simultaneously to avoid reforms being picked off or made more complex in response to lobbying.